The PERAC

Financial Bulletin

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Financial Market Review | Second Quarter, 2000

After the consistent and dramatic outperformance of US large cap growth stocks during the late 1990s, many investment professionals began questioning the value of asset allocation. The discipline of diversifying among asset classes began to win back some skeptics in 1999 as small caps and international stocks flourished. The first half of 2000 has further boosted the morale of asset allocation adherents as such recently unappreciated and unexciting asset classes as bonds, real estate, and even cash have been among the best performers so far this year.

Although overall returns were flat at best, the results of the second quarter were comforting to long-frustrated value equity investors and the stage may well be set for a healthier, more rational market going forward. Continuing a correction that had begun in early March, the quarter saw a definitive bursting of the dot-com bubble as well as major pullbacks in other frothy issues. As investors realized that many "new economy" companies might never succeed or grow fast enough to justify their sky-high market valuations, they bailed out of these stocks. Although it was apparent by mid-year that the technology sector was far from dead, investors were clearly beginning to discriminate strongly in favor of companies that had achieved, or were deemed likely to achieve, profitability and positive cash flow. The days of free capital for anything associated with the Internet have apparently ended, as earnings momentum has supplanted share price momentum as the focus of investors' attention.

The US economy remained robust, with rising oil prices one of the few clouds on the horizon. Nevertheless, the markets were confronted by great uncertainty over the economy's future course. Some fear that the Federal Reserve will not succeed in slowing down the rate of economic growth and dampening fears of inflation. Others worry that the Fed will be *too* successful and will cause a serious economic downturn. In the middle, market optimists are confident that Chairman Greenspan will once again engineer a "soft landing" that will moderately slow the economy in as smooth a transition as possible.

During the second quarter, the Dow Jones Industrial Average, the Standard & Poor's 500, and the Russell 2000 each declined 3–4%. The most volatile index by far was the NASDAQ Composite; on May 23, it was down 37% from its March 10 peak and even after an impressive recovery of almost 17% in June, it was still down 13% for the quarter.

For the first six months of 2000, the S&P 500 was slightly negative. The Dow Jones Industrials were down 9%, as cyclical stocks have been impacted by fears of an economic slowdown and some specific stocks—such (CONTINUED ON PAGE 2)

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(continued from page 1) as Procter & Gamble (-48%), International Paper (-47%), Honeywell (-42%), and AT&T (-38%)—have been hammered particularly hard due to specific earnings or operational concerns. Despite its gut-wrenching volatility, the NASDAQ ended down only 2.5%, as the routing of previous market favorites (such as CMGI, down 67%) was offset by healthy advances registered by a number of new economy stocks judged to have bright prospects for profitability. Widely-held DJIA component Microsoft, beset by antitrust as well as profitability concerns, was down 31% during the first half of 2000.

The best performing sectors during the second quarter were health and biotechnology, real estate, and natural resources. Resurgent drug stocks were paced by Johnson & Johnson, up 45%, and Eli Lilly, up 59%.

In assessing the equity subclasses that most dramatically determined overall portfolio performance in recent years, growth stocks tumbled sharply during the quarter but value stocks failed to really distinguish themselves. Value stocks had begun to make up some ground during the quarter but they lost momentum as concerns rose about a possibly slowing economy. Nevertheless, value stocks did outperform growth in each capitalization class for the quarter but they still trail growth on a year-to-date basis in most comparisons.

Among capitalization classes, mid-caps have been the place to be so far this year. Investors have found more attractive valuations than in large caps and less volatility than in small caps.

Global equities failed to offer any diversifying balance against the volatilty and generally declining values in the US equity market. International equities were down a composite 4% for the quarter. The worst performing region has been the Asian/Pacific countries, with markets in Singapore, Thailand, and Indonesia off 20–40% year-to-date. Economies in that region have rebounded, but perceptions persist that investments in such countries are very risky.

The bond market continued to assess monetary policy and economic trends as well as supply-and-demand conditions. Although the Federal Reserve decided to leave rates unchanged at its late-June meeting, the 50 basis-point hike in the federal funds rate on May 16 marked the central bank's sixth tightening of the past twelve months. However, buttressed by technical support from the government's Treasury bond repurchase program as well as confidence that the Fed's actions will be sufficient to restrain inflation, benchmark Treasury yields were essentially unchanged for the quarter. The yield curve remained inverted with 2-year, 10-year, and 30-year yields being 6.34%, 6.01%, and 5.87%, respectively, as of June 30. Yield spreads between government and corporate bonds remained wide, reflecting in part the diminishing supply of Treasuries as well as the possibility of slower economic growth. With the exception of high-yield ("junk bond") securities, where default rates have been trending higher, most bond indices have been modestly positive both for the quarter and year-to-date.

Shunned by many investors during the growth stock mania of the late 1990s, real estate is enjoying an impressive comeback in 2000. Buoyed by attractive dividend payouts and perceptions of undervaluation by the market, publicly-traded REITs have shown impressive total returns in excess of 13% through June of this year. With the national real estate market appearing to be generally healthy with no major imbalances, privately-held real estate continues to offer consistent moderate returns.

As for venture capital and private equity, actual returns from national surveys are not yet available for any period in the year 2000. Given the drastic valuation decline of many dot-com companies and the softening of the IPO market, returns are likely to be far lower than those of 1999. Despite some reports that investor demand may have peaked, fundraising for new private equity partnerships has continued at a torrid pace.

The second quarter will not be fondly remembered for its absolute returns but it did serve a very important purpose by reinforcing some of the basic rules of investing. First of all, we were reminded that it's impossible to predict how long certain investment fads or manias will persist but that eventually the value of all stocks is dependent on profitability and other fundamentals. Moreover, stocks cannot and do not provide positive returns every year; historically, one out of every four years produces a negative return. Holdings of asset classes such as bonds or real estate with low correlation to US equities will detract from overall performance when stocks do well but they offer valuable support to portfolios when stocks are weak.

In reminding us that the fundamental rules of investment analysis have not been repealed and that any investment instruments that offer attractive potential returns also bear considerable risk, the second quarter of 2000 may have succeeded in restoring a badly needed sense of normalcy to the market.

EDITOR'S NOTE:

Over the past few months, I have enjoyed meeting with several retirement boards across the state. At these meetings, we have discussed asset allocation, performance *issues, market trends, and other investment topics. I have been pleased to participate in consultant meetings and investment manager reviews. These visits have been useful and productive both for the boards and for me, and I look forward to additional meetings over the coming months. I may be reached at (617) 666-4446 ext. 922 for the purpose of scheduling a meeting.*

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PLEASE NOTE:
The PERAC Investment Unit welcomes any comments you may have on this report & encourages all boards to contact us at any time for assistance relating to investment activities. Extra copies of this report are available.

Second Quarter, 2000 | Total Returns

U.S. Equity Market

INDEX	SECOND QUARTER RETURN	2000 YEAR TO DATE
DOW JONES INDUSTRIAL AVG.	-3.98%	-8.47%
STANDARD & POOR'S 500	-2.66%	-0.42%
NASDAQ COMPOSITE	-13.27%	-2.54%
WILSHIRE 5000	-4.34%	0.28%
S&P MIDCAP 400	-3.30%	8.97%
RUSSELL 2000	-3.78%	3.04%

Growth vs. Value

INDEX	SECOND QUARTER RETURN	2000 YEAR TO DATE
S&P 500 GROWTH	-1.47%	2.58%
S&P 500 VALUE	-4.29%	-4.07%
RUSSELL MIDCAP GROWTH	-7.41%	12.15%
RUSSELL MIDCAP VALUE	-1.68%	-0.69%
RUSSELL 2000 GROWTH	-7.37%	1.22%
RUSSELL 2000 VALUE	1.95%	5.85%

Global Equity Markets

INDEX	SECOND QUARTER RETURN	2000 YEAR TO DATE
M.S.C.I. - E.A.F.E	-3.90%	-3.95%
M.S.C.I. - EMERGING MARKETS	-9.46%	-5.06%

Fixed Income

INDEX	SECOND QUARTER RETURN	2000 YEAR TO DATE
LEHMAN BROTHERS AGGREGATE INDEX	1.73%	3.98%
LEHMAN BROTHERS GOVERNMENT/ CORPORATE INDEX	1.45%	4.16%
FIRST BOSTON HIGH-YIELD INDEX	0.45%	-0.84%

Real Estate

INDEX	SECOND QUARTER RETURN	2000 YEAR TO DATE
NAREIT - EQUITY REAL ESTATE INVESTMENT TRUSTS	10.53%	13.18%
NCREIF PROPERTY INDEX	2.31(1Q)	5.31% (TRAILING 6 MONTHS)

Report on First Quarter Investment Performance

As of this date, PERAC has received sufficient investment return data from 60 retirement systems to allow the calculation of total return for the first quarter of 2000. These returns are listed below.

The median return for these systems was slightly below 4%. Twenty–five of the completed systems had returns of 4% or higher.

These returns look very favorable since a calculation of expected average performance based on composite asset allocation percentages and benchmark returns of major asset classes yields a return of about 2.75%. Additionally, some surveys by investment consultants indicate that typical first quarter performance by public pension funds nationwide was also in the 2.75% range.

Recapitulating the first quarter's financial market returns, major asset class benchmark returns were 3.8% for US stocks (Wilshire 5000), -0.05% for global stocks (MSCI-EAFE), 2.2% for bonds (Lehman Brothers Aggregate), and 2.3% for real estate (NCREIF).

Going forward, PERAC urges all retirement boards to work toward having all investment return data submitted on a timely basis so that we may provide you with useful compilations and analyses of system-wide performance as soon as possible after each quarter.

2000 Returns

Retirement Board	First Quarter	Retirement Board	First Quarter
Adams	0.41%	Maynard	4.53%
Amesbury	3.49%	Medford	5.44%
Andover	8.42%	Methuen	7.87%
Arlington	2.54%	Milford	4.87%
Attleboro	3.51%	Milton	3.41%
Belmont	0.34%	Minutemen Reg. Voc.	3.93%
Berkshire County	3.92%	Montague	4.02%
Beverly	4.44%	Natick	-2.33%
Blue Hills	8.63%	Needham	4.01%
Braintree	2.63%	Newburyport	3.92%
Cambridge	3.63%	Newton	3.71%
Chicopee	2.87%	North Adams	9.70%
Concord	3.65%	Northampton	9.42%
Dedham	4.04%	Northbridge	4.03%
Everett	3.38%	Peabody	1.64%
Fairhaven	4.01%	Pittsfield	1.60%
Fall River	2.43%	Plymouth	1.32%
Fitchburg	4.50%	Reading	4.05%
Framingham	4.21%	Revere	3.90%
Gardner	4.16%	Salem	3.44%
Greenfield	8.68%	Saugus	3.97%
Hampden County	2.05%	Shrewsbury	3.22%
Hingham	4.01%	State Employees	3.96%
Holyoke	3.13%	State Teachers	3.96%
Hull	7.01%	Taunton	3.61%
Lynn	3.55%	Wakefield	4.04%
Malden	12.47%	West Springfield	2.39%
Marblehead	3.95%	Westfield	4.91%
Marlborough	2.23%	Weymouth	3.90%
Mass Turnpike	1.64%	Winchester	5.01%

Dow Jones Industrial Average: A price-weighted index tracking thirty large industrial companies selected by the editors of *The Wall Street Journal.*

Standard & Poor's 500 Index: A broad-based market index, weighted by market capitalization, that comprises about 75% of the total market value of publicly traded US equities.

NASDAQ: The National Association of Securities Dealers Automated Quotation System is an over-the-counter trading exchange used mainly by newer, technology-oriented companies.

Russell 2000: The major index that tracks small capitalization stocks.

Large Capitalization Stock: Total market value of outstanding stock exceeds $5 billion.

Mid-cap stock: Between $1.5–5 billion in market capitalization.

Small-cap stock: Less than $1.5 billion market value of stock outstanding.

Growth stock: Stock of companies that, due to their strong earnings potential, offer above-average prospects for capital appreciation, with less emphasis on dividend income.

Value stock: Stocks that, considering a company's assets and earnings history, are attractively priced relative to current market standards of price-to-earnings ratios, price-to-book ratios, et al. They typically pay regular dividends to shareholders.

Price/Earnings Ratio: Sometimes referred to as the "multiple", the P/E Ratio is the stock price divided by the company's net income per share over the past twelve months.

Treasury yield: The current market interest rate on bonds issued by the US Treasury with a specific maturity date (i.e. 30 years). Bonds are issued at a specific interest rate and at a specific price (such as 100 or "par") but the subsequent price and yield will be determined every day by prevailing market conditions. If rates generally rise (fall) after initial issuance, the price of the original bond will fall (rise) in order to make the effective yield on the bond rise (fall) to a level consistent with those on currently issued securities.

Corporate bond spread: The "spread" is the incremental yield offered by corporate bond issuers over those of US Treasury securities of similar maturity. The spread is a measure of investors' willingness to assume the extra credit risk inherent in corporate securities compared to virtually riskless US Treasuries.

Federal Funds Rate: The rate at which reserve funds ($1 million or more) are traded among commercial banks on an overnight basis.

High-yield ("junk") bonds: Bonds rated below investment grade issued by corporations whose overall business or financial condition is relatively weak or risky. These bonds react less to general interest rate trends than do investment grade securities.